CREDIT REFORMATION

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In the presence of conditions in this country approximating the normal, money or currency cares for just about four per cent of the average daily amount of its business. Credit, in open account or credit instruments such as checks, notes and bills of exchange, liquidates the remainder, either immediately or at some future date. Seriously disturb this usual relation, and for any reason impose upon business a settlement in cash of 10 per cent of its volume, and we have panic, whether severe or mild being dependent upon conditions developed from the use, or more properly the abuse, of credit. While credits in one form or another, aggregating an enormous total, are granted by sellers to purchasers, the banks of the country are, shall we say, the impersonal agencies which, in undertaking the responsibility of collecting free capital into reservoirs, loan it to that part of the business public needing accommodation. The measure of ability of any bank to extend credit, generally speaking, is the net liability of such bank to its depositors. Withdraw deposits in any material degree and a bank is required to demand payment of outstanding loans or reinforce its cash by borrowing. In normal times and in local situations, either remedy is usually available, but when times are out of joint, as for instance when over-expansion of credit becomes all too apparent and is evidenced in country-wide conditions, this ability either to collect maturing obligations or to borrow in order to meet deposit withdrawals is seriously abridged or altogether lost. As actual cash reserves held by the banks hardly average more than seven per cent of their deposit liability, it is easily seen that a relatively small demand for the payment of deposits in actual lawful money must so deplete their resources as to compel suspension of payments, something which has occurred several times, making it imperative to resort to extra legal and unsound practices, tolerated simply as a matter of immediate necessity. The under-

lying cause of panic has been the knowledge, gradually appreciated, that a preponderant or disproportionate share of outstanding credits was based, not upon commodity movements to be liquidated in trade terms from the sale of merchandise, but upon investments in land, buildings, machinery, etc., upon which prompt realization would be impossible, or in speculative stock holdings held at inflated values. Symptoms of disorder being present, trouble has more certainly followed for the reason that the banking machinery of the country up to a year ago provided no adequate means either of preventing serious credit abuses or of intelligently ameliorating if not actually preventing the consequences of such abuse.

The country has owned say twenty-five thousand banks, each an independent unit, each in strong competition for business with the others, and all so self-sufficient and jealous of their own "rights" that in the absence of any coördinative authority, only in the actual presence of a panic could they be persuaded to coöperate and make common cause against a common danger. Prompted by the instinct of self-preservation, each bank in endeavoring to force payments from debtors, either unwilling or more likely unable to meet maturing obligations, at the same time would decline to make new loans and, in reinforcing its cash reserves, exaggerate a situation already difficult.

Under the old order, by far the greater number of banks, in placing their loans, were satisfied in feeling that their advances were based upon values which ultimately could be realized. The ability to collect obligations at maturity was thought to be a matter of secondary moment. Indeed, the due date of a piece of paper had come to mean, in a vast number of cases, only a bookkeeping memorandum or a time at or about which a maker might be expected to call with the idea of making a renewal note and paying interest or discount. It was only the exceptional bank which really was sufficient unto itself in holding some fair percentage of its assets in position permitting liquidation in due course and without distress to borrowers. The average bank apparently was conducted upon the theory that *it* was absolved from following sound banking practice, that it could tie up its assets in long time, fixed or slow investments, and that it always would be able in case of real need, to find some correspondent to extend a helping hand. Commonly the required aid has been

forthcoming and in its granting has served to encourage the bad habits responsible for this need. As a matter of fact, it many times is the case that the more reckless or improvident the banker who, by the grace of an amiable reserve depositary, is able to escape the natural consequences of his shortsightedness, the more certain is the banker—after it is all over—that he really is a great financier. When, however, with substantially one consent all banks need help at the same time, and old harbors cannot hold all of the distressed ships, those outside the anchorage are apt to experience rough weather if not disaster.

For many years, this country in developing its business of all kinds and, under the impetus of keen and oftentimes unsafe competition in very many lines, in too heavily discounting the future, has been greatly abusing credit rules accepted as sound by every other commercial nation. It is true that in owning only a most incomplete and inefficient code of banking law, which provided no means of serving many most important and necessary situations requiring the aid of the money lender, the commercial banks have been called upon and used in a manner never contemplated fifty years ago. In consequence, conditions recognized as unsound have become so fixed as to make very difficult the task of reorganizing banking on lines which, while having safety in view, will at the same time be fair to interests which have come to look upon indulged or permitted practices as vested rights. At the larger centers, and, generally speaking, in certain districts of the country where a more or less full development of natural resources has permitted specializing in banking, we find established side by side several classes of financial institutions, each differing from the others oftentimes in undertaking primarily some particular line of banking, but, and most unfortunately, each quite frequently, in connection with its own specialty, trespassing upon primary business of a neighbor, thus inducing destructive competition. In such sections, we find commercial banks, financial banks, mutual savings banks, stock savings banks, so called finance companies engaged in purchasing book accounts, building and loan associations, both mutual and stock companies, the trust company proper and the trust company improper. All touch each other, and, broadly speaking, are in such close competition that fundamental credit rules admittedly sound are trifled with if not altogether

disregarded. The result has been that not only is over-trading by sometime sound customers greatly encouraged, but credit is otherwise so freely extended as to make a mockery of rules, which each bank feels should be the guide of the other fellow.

When we leave the relatively highly developed sections, centers of large population, we come to the smaller communities, then to the rural neighborhoods, and finally to the sparsely settled territory where the employment of a scant capital supply means unusual risk. As we proceed, we note that while all of the smaller neighborhoods offer some business of all of the kinds cared for in the large cities, there is not enough of any single line to permit specializing, with the very natural and proper consequence that three, two, and finally a single institution will undertake to care for all of the banking needs of a community. It most unhappily also is true that forty-eight states have as many different codes of laws governing banking within their respective jurisdictions, while national legislation, in attempting to standardize certain banking practices, has possibly suggested, if not induced, the enactment of competitive, if not hostile, state legislation.

Into such a mixed, contradictory and dangerous banking and credit situation was injected in December, 1913, the Federal Reserve Act. The law, in recognizing conditions as made by practice encouraged or permitted under older statutes, at the same time mapped out a program which, in the following, gradually will permit banking and business in this country to be readjusted on sound lines and in conformity with world practice. The new law emphasizes the difference between credits extended in furthering the development of trade and commerce, and credit to be used in fixed, non-liquid situations or for investment or speculative purposes, and in providing means to aid in the production, manufacture and distribution of commodities, makes readily available for credit purposes, negotiable paper based upon such commodity transactions.

Years ago, when a merchant sold a bill of goods, he would receive from his customer either a note or acceptance for the value of the invoice, when both parties to the transaction would expect the account to be closed by payment of the obligation at its stated maturity, made in conformity with trade practice. Such a merchant when needing credit would offer a bank his customers'

obligations bearing his endorsement, two-name paper reflecting a bona fide sale and purchase. As the result of competition, which took the form not only of price and profit cutting but of settlement terms, the one time usual note or acceptance has practically disappeared from many lines of trade, and in its place we have on one side of the ledger "open accounts due from customers," while among liabilities appear "bills payable," the direct and generally unsupported obligation of the merchant. Such notes issued against the general assets of their makers are what is known as "single-name paper." If one could be sure that the average merchant would be proof against the temptation either to overtrade or to inflate reported value of assets, a single-name note against liquid assets such as good book accounts, would be just as good and as readily collectible as would be the note of one or more debtors endorsed by the merchant. Unfortunately, however, a very great number of traders do not limit their borrowings to an amount fairly related to the total of quickly realizable inventory and book accounts made for settlement at a determined date. A great many people, especially manufacturers, who are required to make relatively heavy investments in fixed directions, as for instance, in real estate or plant account, seem to feel that if their notes are good at bottom, that is, upon liquidation of their business, a bank liable for deposits payable on demand should be fully satisfied in making them advances out of all proportion to quick assets. Again, a man in business will oftentimes invest in land or securities so closely as so to "skin" his bank account as to make him a chronic borrower. This means that a bank in holding his unliquid note, is, in continuously furnishing capital, practically his partner in business. Once more, it has come to be the habit that three or four men will incorporate for a nominal paid in capital and then expect to conduct a large business on borrowed money for which is given the note of the small corporation with the surety endorsements of its owners.

None of these severally described notes should be accepted by a bank having proper respect for its own obligation to depositors, and, most properly, none of such sort of paper is eligible for discount by a federal reserve bank, which as a matter of prime necessity must keep its assets in liquid position. With the development of the system, the average bank, in appreciating that its non-liquid

loans are not available when it needs help, will surely sharply discriminate against such loans to the good both of the banks and the borrowers of the classes indicated.

Many merchants enjoying good credit on their single-name paper are averse to returning to old time practices, as under existing conditions such merchants really are doing a banking business on quite a generous scale. They are able to borrow on close terms, when they extend open credit to their customers on terms which many times yield not only two to four per cent profit on the credit itself, but higher prices for goods than otherwise would be paid. Not only is the banker's field thus usurped, but the customer is trained to postpone pay day. The chief insecurity to creditors in "open accounts" arises from the fact that the caption may mean much or little of value, dependent upon the reliability of a merchant or the adroitness of a bookkeeper. Such a heading may include long overdue or worthless accounts, or the drawings of partners in actual reduction of their reported responsibility. A fruitful and increasing source of danger to a creditor relying upon quick assets arises from the sale or pledge of specific assets. Any practice which will result in preventing the sale or pledge of reported assets, with any continuing liability to the seller, should be welcomed not only by the banks but by the safe and sound business public. In a desire to induce if not compel a return to the habits of a time when each sale of merchandise was reflected in the instrument used in settlement, the reserve banks, under the guidance of the Reserve Board, have established preferential rates for "trade acceptances." Just as soon as the business public as a class appreciates the significance of this action, it will not only set about obtaining such acceptances, but, when using them at bank, will expect such papers to be accorded a favored rate. Under the law, rates have been equalized and stabilized to all the banks of the country, and just as soon as the public realizes what has happened, it also will enjoy the same benefits.

The law draws sharp distinctions between the classes of paper which may or may not be accepted by reserve banks. Within the limits set by law, the Reserve Board is required to formulate definitions and regulations for the guidance of the banks. This task has been anything but a simple one, and in consequence, in defining the several classes of paper eligible for rediscount, it was

necessary not only to have in mind an ideal impossible of attainment at the moment, but conditions known to exist. Practically every adult male, engaged in business of any kind and called upon to describe a piece of commercial paper, would at once say that it would be an instrument given by a purchaser of merchandise to a vendor, and that when negotiated it would be upon the responsibility of the two parties primarily concerned in the transaction. It would just as clearly be understood that a "single-name" note was not commercial paper.

As in practice the banks handle a great volume of single-name notes and only an insignificant quantity of real commercial paper, a definition under which the reserve banks would be restricted to the acceptance only of commercial paper proper would not have permitted the reserve banks to be of any service whatever to the country. In this as in many other respects, the Reserve Board, in recognizing conditions as they have existed, most certainly has in mind the purpose to raise the standard of eligibility just as soon as the leaven of education has time to do its work.

The aim of the reserve banks is to accept only paper made for payment by its makers, and where a maturity will mean a date of liquidation and not merely a convenient time for dropping in for the purpose of paying interest and leaving a renewal. Paper held by the reserve banks is to be part of the security upon which the currency of the country is to rest, and obviously it is essential that this security be sound and real. To insure such qualities, the reserve banks must have satisfactory evidence of the ability of makers to fulfill their engagements, and in this connection it is required that borrowers' statements be furnished for analysis and independent investigation. It is surprising to learn of the number of banks in the country, especially many of those in the smaller or rural communities, which, in never having demanded statements from borrowers, loan them money on blind faith in their assumed knowledge of a customer's affairs. Under the necessity of furnishing such statements to a reserve bank, a great many member institutions have been obtaining them from customers, and strange to say, without meeting the trouble anticipated, when in very many instances the member bank in turn is surprised, sometimes pleasantly but often the reverse, until many banks have expressed appreciation of this particular result of the development

of the law. Any single reserve bank in holding such statements has the means of learning where and when credit is being abused, and will be able efficiently to correct such abuses, to the very material help of members, each of whom many times feels that some particular customer is doing all of his borrowing at home. Eventually, and particularly in connection with accounts of large borrowers, this credit information will be tabulated and assembled at some common center, there to serve all the reserve institutions and through them the member banks. Then will be the time in which, as not before in this country for many years, the obligations of the borrower made to be paid will bear some proper relation to the really available resources of such borrower. Then also, business men, in being denied the privilege to overtrade for the reason that their paper will not be eligible for discount, will, in relying more upon their own resources, including proper credit, be less exposed to temptation to take undue risks to the hazard not only of themselves but of the banks.